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TAGS: [ECON](#) [EFIN](#) [PGOV](#) [VE](#)
SUBJECT: INFLATION STARTING TO TAKE ITS TOLL ON VENEZUELA'S
POOR

REF: A. CARACAS 276
[1](#)B. CARACAS 190
[1](#)C. CARACAS 174 AND PREVIOUS
[1](#)D. CARACAS 86
[1](#)E. 2007 CARACAS 2381

Classified By: Acting Economic Counselor Shawn Flatt for reasons 1.4 (b)
) and (d).

[1](#)1. (C) Summary: Inflation, including the repressed inflation reflected in rolling shortages of price-controlled goods, is quickly becoming a stone around the neck of the BRV's economic management team. While most independent and opposition-aligned economic analysts agree that the primary cause of inflation is record demand driven by record government spending, the BRV has not resented a coherent macroeconomic plan for dealing with inflation. Over the past several years, the BRV has trusted that its ability to channel resources to Chavez' political base in Venezuela's poorest socioeconomic classes would outweigh the negative impact of inflation on this group. Indications are that the BRV was much less successful in this regard in 2007 than in previous years: contacts in the social sciences believe that the poor are strongly feeling the bite of inflation and that their real purchasing power is growing at a sharply reduced rate, if at all. It will be difficult and costly for the BRV to reverse this trend in 2008, particularly given strong inflationary expectations. End summary.

A Fiscal Boom Leads to Growth and Inflation

[1](#)2. (U) As BRV officials are quick to point out, Venezuela's economy recovered quickly from its low point in 2002 and 2003, when a national strike compounded the effects of an incipient recession. One key driver of this recovery, which has seen real annual economic growth rates from 8 percent (2004) to 8 percent (2007), has been the BRV's expansive fiscal policy. According to the Central Bank (BCV), central government spending rose an astounding 140 percent in nominal terms from 2004 to 2007, although the rate of increase slowed in 2007. (Note: The BCV figures do not reflect billions of dollars of quasifiscal spending by entities such as PDVSA (which supplies some funding directly to missions, for example) and the national development fund FONDEN. The limited information available suggests that quasifiscal spending grew dramatically in 2006 relative to 2005 and may have averaged USD 12.5 billion per year in 2006 and 2007. In contrast, on-budget central government spending was approximately USD 58 billion in 2007, when converted from bolivars at the official exchange rate. End note.)

[1](#)3. (U) Independent and opposition-aligned economic analysts agree that government spending has been the single most important cause of a huge increase in aggregate demand, which in turn, in the absence of a corresponding increase in supply, has led to annual inflation varying between 14 percent (2005) to 22 percent (2007), as measured by the official Consumer Price Index (CPI) for metropolitan Caracas. Shortages of price-controlled goods which reflect repressed inflation, are a related and significant problem (ref E). Because the BC's CPI methodology does not adequately correct for shortages of price-controlled goods, actual inflation is likely even higher (at least in Caracas) than the CPI indicates. Most local economists expect inflation in 2008 to be higher than in 2007, and inflationary expectations appear increasingly widespread in the general public.

14. (SBU) While conventional wisdom is that the poor have the most to lose from inflation, over the past four to five years the BRV has generally succeeded in directing resources to Chavez' political base, particularly Venezuela's poor, such that they have gained far more than they lost. Some initiatives, such as the subsidized food distribution program

known as Mercal, broadly benefited the poor. Others, for example Mission Robinson (a literacy program), provided stipends to participants, who were generally expected to support Chavez' political initiatives. The BRV also used the Tascon list, which contained the names and identification numbers of Venezuelans who signed a petition in support of a presidential recall referendum, to direct increased public employment opportunities to Chavez supporters and to deny benefits to his opponents.

15. (SBU) Social and economic analysts agree that as a result of these policies the purchasing power of Venezuela's poor has risen faster in percentage terms since 2003 than that of the middle class or wealthy. Joseph Saade (strictly protect throughout), Executive President of Datos, a leading market research firm, estimates that real purchasing power of the "E" class (the poorest Venezuelans, roughly half of the population) grew a stunning 181 percent from the end of 2003 through 2007, as compared with 12 percent for the "D" class and negative 7 percent for the "C" class (the middle class). (Note: To calculate changes in real purchasing power, Datos estimates nominal income per household by class based on its survey and then deflates by the CPI. Given Datos' methodology for estimating nominal income, it is the comparative trends, rather than the exact figures, that are most meaningful. End note.)

2007: An Inflection Year?

16. (C) All indications are that in 2007 the BRV did not enjoy the same success as in previous years at compensating Chavez' political base to take the sting out of inflation. While their numbers are slightly different, both Saade and Luis Pedro Espana (strictly protect throughout), director of the Institute for Economic and Social Research (IIES) at the Universidad Catolica Andres Bello, estimate that in 2007 real purchasing power of the E class grew at roughly the same rate as that of other socioeconomic classes and as the economy as a whole (i.e., roughly 8 to 10 percent). These figures do not fully take into account the impact of the shortages on Venezuelans' economic well-being. Survey data suggest that the percentage of Venezuelans who consider shortages a problem grew significantly during 2007, across all social classes, reaching an average of 78 percent by year end. Finally, anecdotal evidence indicates that the perceived quality of services offered by missions also dropped and that direct stipends paid by the missions also declined. According to one political economist, Mercal's "market share" in the provision of basic foodstuffs dropped from 36 percent in 2004 to 24 percent in 2007. Given these additional factors, as well as the fact that the CPI likely understates inflation, Saade speculated that poorer Venezuelans might actually have felt worse off economically by the end of 2007 than they did at the beginning.

17. (C) Why the BRV was less successful at shielding Chavez' political base from inflation and shortages in 2007, particularly given the political imperative of the December 2007 constitutional referendum, is an open question. IIES social scientist Maria Gabriel Ponce (strictly protect throughout), Banco Mercantil economist Rafael Munoz (strictly protect throughout), and economist Miguel Angel Santos (strictly protect throughout) all pointed to increasingly poor management, corruption, and/or clientelism in the missions and government institutions as key factors. Munoz and economic consultant Ruth de Krivoy (strictly protect throughout) believe that Chavez' overconfidence caused him not to focus on inflation and shortages to the extent he should have. Munoz opined that Chavez, thinking he had consolidated political power, shifted resources from the missions to the promotion of "socialist methods of production" such as cooperatives.

2008: Corrective Action or More Spending?

18. (SBU) BRV officials, including Chavez, have publicly acknowledged that inflation and shortages are problems. While the BRV has taken a number of discrete measures since the referendum designed, in theory, to alleviate shortages (ref C; others septel), government officials have offered neither a consistent and credible explanation for inflation nor a plan to deal with it. In its 2007 end of year message, the BCV acknowledged that increased demand associated with 4 years of economic growth was a factor; other officials, including Chavez, frequently note that prices have increased internationally; and newly appointed Finance Minister Isea said that speculation and "unscrupulous merchants" were among

a "slew of reasons" behind inflation. In late January, Isea assured the public that the BRV's new economic team would take measures to keep inflation "within acceptable limits," and in a February 24 interview Planning Minister Haiman El Troudi promised that the BRV would announce within days a well-developed plan with fiscal and monetary measures to control inflation.

19. (C) The BRV has recently adopted some monetary policy measures designed to reduce liquidity growth, including withdrawing some public funds from the banking system and selling dollar-denominated bonds on the parallel market (ref B). On February 29, the BCV announced further tightening of monetary policy, raising the interest rate floor on several types of deposits and the ceiling on credit card loans. Yet almost all of our economic contacts believe that Chavez, as he has done in the past, will choose to boost fiscal spending, to the extent possible, in the run-up to the elections for mayors and governors scheduled for November 2008. Munoz pointed to preliminary spending figures published by the Office of the Treasury as a sign that this fiscal push has already begun. Other indicators include the creation of PDVAL, a subsidiary of PDVSA devoted to producing and distributing basic food products (ref D); announced increases to budgets of three missions (Barrio Adentro, Ribas, and Sucre); and various hints at minimum wage and public sector salary increases. While monetary policy measures may reduce secondary expansion of the money supply, economic contacts argue, they cannot bring down inflation in the face of fiscal expansion and inflationary expectations.

Comment

10. (C) As Chavez sees his popularity fall in part because of inflation and shortages, we also expect him to try to revert to the formula that proved successful from late 2003 into 2006, namely compensating his political base such that they are better off in spite of inflation and shortages. It will be very difficult for the BRV to repeat its past success, however. The economic growth of the past several years has raised expectations and income levels among Chavez' base, which means that it would take a greater transfer of resources to achieve the same results. As noted above, the efficiency of the missions (and other transfer mechanisms) seems to have declined. It is probably becoming more difficult for the BRV to target Chavez' desired political base adequately using strict socioeconomic criteria, as a number of Chavistas have taken advantage of new opportunities to improve their socioeconomic standing. The recent creation of PDVAL also suggests that Chavez sees a need to reach out to the middle class, as opposed to focusing solely on the poor. Finally, PDVSA's cash flow problems (ref A) suggest that money for social programs may get tighter. In short, Chavez is getting less political bang for every dollar of spending, and the more he spends the more the resultant inflation will reduce the rate of return on the next dollar.
DUDDY